

SPECIAL REPORT

**Issues Related to
Office for Information Resources'
ITPRO Contracts
April 2003**

**John G. Morgan
Comptroller of the Treasury**



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John G. Morgan
Comptroller

April 3, 2003

The Honorable Phil Bredesen, Governor
The Honorable John S. Wilder
Speaker of the Senate
The Honorable Jimmy Naifeh
Speaker of the House of Representatives
The Honorable Dave Goetz, Jr., Chairman
Information Systems Council
and
Members of the General Assembly
State Capitol
Nashville, Tennessee 37243

Ladies and Gentlemen:

Transmitted herewith is this office's report on issues related to the state's ITPRO contracts.

Sincerely,

John G. Morgan
Comptroller of the Treasury

JGM/ab

ISSUES RELATED TO THE STATE'S ITPRO CONTRACTS

April 2003

**Office for Information Resources, Department of Finance and Administration
Department of Labor and Workforce Development**

The objective of the Information Technology Professional Services (ITPRO) contracts is to provide state agencies with qualified Information Technology professionals to perform software programming, software system modifications, and database administration services. The Office for Information Resources (OIR) within the Department of Finance and Administration entered into contracts in 1997 with seven vendors to provide state agencies with a flexible means of obtaining qualified personnel to meet their information technology needs. Agencies have used the contract to secure the services of contractors to both develop and program systems and databases, and systems analysts to support the maintenance of existing applications. Other uses for contractors include providing support for advanced Web development, technical support to repair desktop computers, and assistance with agency help desks. Agencies wishing to use a contractor must submit to the vendors a Statement of Work (SOW) that details the nature of the work to be performed, and then select a contractor based on a structured, competitive process. As of December 2002, 277 ITPRO contractors were being used by 16 state agencies. According to information provided by OIR, the amount paid for ITPRO contracts for the period July 1, 2001, through December 31, 2002, was \$39,592,877.05.

ISSUE AREAS AND MATTERS FOR ACTION:

I. EXCESSIVE OVERBILLINGS IN THE DEPARTMENT OF LABOR AND WORKFORCE DEVELOPMENT AND RELATED ISSUES FOR THE DEPARTMENT AND OIR

A. Two contractors working for the Department of Labor and Workforce Development have engaged in major overbilling.

- Both contractors admitted that they overbilled the department for hours worked, billing for 16-hour days, seven days per week, over successive pay periods.
- The actual amounts of overbilling are still being assessed, and a subsequent report will follow.

- The possibility of the overbillings was brought to the attention of the Division of State Audit by the Department of Labor and Workforce Development.
- The department and OIR are cooperating with the review of the details.

B. OIR had information stating the billings were excessive, but OIR authorized and made the payments anyway.

- OIR staff responsible for reconciling timesheets and invoices identified pay periods where the two contractors submitted “outrageous” numbers of hours, and notified both the department and OIR management of the situation.
- Despite information that excessive overtime was being billed, payments were authorized.
- OIR does not have written policies or guidelines concerning how to address potential overbilling.
- However, its informal policy is to make payments provided documentation is submitted in the form of signed timesheets approved by the department using the contractors, even if the hours appear excessive.

C. The Department of Labor and Workforce Development failed to adequately monitor the hours of the two contractors.

- The department employee who supervised their work and signed their timesheets acknowledged that he provided little oversight.
- In addition, this individual authorized OIR to make payments for the hours even after being notified by staff of OIR there were questions as to their accuracy.

II. ISSUES RELATED TO THE USE OF ITPRO CONTRACTORS RATHER THAN STATE EMPLOYEES

A. The use of ITPRO contractors by state agencies is not cost-effective to the state.

The spread between the cost of an ITPRO contract position and a state employee position depends on several factors, including

- the salary the state can convince someone, perhaps an ITPRO contractor, to accept as a state employee, and
- the costs of the benefits the state provides to state employees.

Still,

The state pays vendors rates that are more than what the vendors pay the contractors. In the cases we reviewed that difference has always been more than the additional costs of the typical related benefit package for a state employee (22-24% of base salary). Thus, the state could convert necessary contract positions into full-time state employee positions without any extra funding.

The extra cost involved in using the contractors contributes to the problem defined by state officials that the state cannot afford to hire state employees for these positions by implying that, de facto, those costs represent the cost of employees that would be required to do the work in question. However, such a generalization is not consistent with the circumstances in which contractors are working side by side with state employees.

In 2002, there were indications that the Department of Finance and Administration was seriously committed to a widespread statewide conversion of ITPRO contract positions to full-time state positions for many of the reasons outlined in this report.

In anticipation of that change in philosophy, OIR and several state agencies began to develop plans for effectuating the conversions, including cost comparisons. OIR, for example, projected an annual cost savings of \$2.3 million for converting all 103 OIR-managed ITPRO positions (excluding agency-managed contractors). OIR management has estimated that a statewide conversion of all ITPRO positions could result in annual savings of \$4 million to \$5 million for the state.

Although officials of the Department of Finance and Administration had clearly indicated earlier in 2002 that they planned to move forward with a statewide conversion of ITPRO contract positions to full-time state positions, that decision was abruptly changed in late 2002. This change was made notwithstanding the information that had been developed indicating potential cost savings through the conversion.

As a result of that change in direction, the initial statewide proposal was scaled back to an approval to convert only 15 OIR contractors into state employee positions. As of January 2003, 7 of the 15 conversions had been completed, resulting in cost savings for the seven positions of 42.6%, 37.3%, 16.5%, 12.7%, 12.5%, 12.4%, and 9.7%. These initial seven conversions resulted in an annual savings to the state of \$138,548 from the total annual payments to the vendors of \$617,103, an average savings of 22.5%.

The Comptroller of the Treasury converted an ITPRO contract position to full-time state employment status in December 2002, resulting in an annual cost savings of \$4,884, or 6%. While the savings are smaller than the OIR conversions, they are savings nonetheless, and the legal questions of employee status which are discussed below have been eliminated.

B. Both state officials and department management appear to have accepted the use of ITPRO contracts as the only way to meet their IT needs.

- The widespread growth of use of ITPRO contractors in the mid to late 1990s can partly be attributed to the need for programmers to meet the challenges of Y2K.
- After the Y2K challenge had been met however, agencies did not significantly reduce or terminate the use of contractors.
- Rather, the contractors have become permanent fixtures for agencies.
- By using the self-fulfilling prophecy that the state cannot recruit technical people for these needs, responsible state officials have failed to take meaningful steps to seek such employees.
- Department IT management assert that a combination of hiring restrictions, cumbersome and inflexible Department of Personnel registers, and inability to pay IT personnel the salaries their skill and experience levels demand, limit their ability to meet their needs with state employees.

C. Although the ITPRO contracts require state agencies to submit project-specific Statements of Work (SOWs) to justify the use of contractors for projects, the majority of agencies are submitting poorly defined statements that simply specify the labor classifications and job skills necessary to perform certain types of work.

- This allows the agencies to select contractors to perform services that merely supplement the routine work of their in-house information technology staff.
- In many cases, the services provided by the contractors could be performed by state employees, if agencies were allowed to establish and fill the positions.

D. The manner by which agencies utilize and supervise ITPRO contractors raises serious legal questions about whether the contractors may be, in effect, state employees.

- We have not examined the specific facts of each agency's use of the contractors. However, the state might be liable for, among other things, the actions of the contractors in tort cases, as well as for the payment of their benefits including retroactive retirement benefits and workman's compensation, if a court were to determine them to be state employees.

With regard to the ITPRO contractors, it appears that the manner by which they are utilized by agencies meets multiple tests and criteria established by the IRS and upheld by Tennessee case law defining employee status. The fact that agencies control the manner by which contractors perform services; the working hours, workplace arrangements and assignments, and pay methods used for

contractors; the ability of agencies to terminate contractors; the fact that contractors perform services that supplement agency staff as opposed to performing project-related engagements; and the continuing tenure of most contractors all meet the criteria that define employee status.

- The IRS has established 20 criteria to indicate whether an employer-employee relationship is present. They include

INSTRUCTIONS: *A worker who is required to comply with other persons' instructions about when, where, and how he or she is to work is ordinarily an employee. This control factor is present if the person or persons for whom the services are performed had the RIGHT to require compliance with instructions.* [In general, agencies direct the ITPRO contractors in performing work. Agencies control the manner by which the work is to be performed either by requiring contractors to follow processes or by directing contractors to accomplish work in a manner consistent with the activities of full-time state employees of the agencies.]

SERVICES RENDERED PERSONALLY: *If the services must be rendered personally, presumably the person or persons for whom the services are performed are interested in the methods used to accomplish the work as well as the results.* [In the case of the ITPRO contractors, they work on-site, under the direct supervision of agency personnel.]

CONTINUING RELATIONSHIP: *A continuing relationship between the worker and the person or persons for whom the services are performed indicates that an employer-employee relationship exists. A continuing relationship may exist where work is performed at frequently recurring although irregular intervals.* [Most ITPRO contractors appear to clearly meet this test. As of December 2002, 174 of 277 contractors, or 63 percent, had been working with the same agency for two or more consecutive years.]

SET HOURS OF WORK: *The establishment of set hours of work by the person or persons for whom the services are performed is a factor indicating control.* [The ITPRO contractors in general work an established 8-hour day schedule.]

FULL TIME REQUIRED: *If the worker must devote substantially full time to the business of the person or persons for whom the services are performed, such person or persons have control over the amount of time the worker spends working and impliedly restrict the worker from doing other gainful work. An independent contractor, on the other hand, is free to work when and for whom he or she chooses.* [The ITPRO contractors meet this criteria by working 40-hour weeks for lengthy periods of one or more years, devoting full-time services to the agency.]

RIGHT TO DISCHARGE: *The right to discharge a worker is a factor indicating that the worker is an employee and the person possessing the right is an employer. An employer exercises control through the threat of dismissal, which causes the worker to obey the employer's instructions.* [Agency IT management believe an important feature of ITPRO contracts is the ability and ease of terminating contractors.]

METHOD OF PAYMENT: *Payment by the hour, week, or month generally points to an employer-employee relationship, provided that this method of payment is not just a convenient way of paying a lump sum agreed upon as the cost of the job.* [The ITPRO contractors are paid an hourly rate of pay that was established by the SOW competitive bidding process.]

Tennessee case law emphasizes many of the same criteria established by the IRS. Courts have held that the basis of liability is the employer/employee relationship. Tennessee Case law decisions have included the following factors to consider when making the determination of employment status:

- furnishing of equipment,
- right to control the conduct of the work,
- right of termination,
- method of payment, and
- whether one (i.e., the contractor) is doing work for another entity.

According to an opinion of the Tennessee Attorney General's Office, state courts have held that while no single test is necessarily dispositive, the importance of the right to control the conduct of the work has been repeatedly emphasized.

The Courts and the IRS point out that each case is determined on the specific facts of that situation. However, it appears that the manner by which agencies control the work of ITPRO contractors clearly meets this test.

E. By supplanting state employees with contract labor, state officials are able to incorrectly publicize they are "holding down the size of state government."

- In fact, when the extra costs of the contractors is considered, primarily vendor overhead costs, the effect is to actually increase state costs while pretending to cut costs.
- Because contractors are paid through contracted services budget codes as opposed to personnel salary budget codes, these payments can be made, while claiming that salaries and state positions are being reduced.

- In other words, the departments are already spending the money for these services and are paying more than is necessary.
 - Replacing the contractors with full-time state employees would mean less expenditures of scarce state resources.
1. OIR at times has in effect served as a rubber stamp in approving contractor requests from agencies.
 - Even though agencies have to submit letters to OIR to justify using an ITPRO contractor, the requests are seldom rejected, and when they are, it is because the agency failed to include some necessary information.
 - After information is submitted, the requests are approved.
 2. Although there is a need for some outside assistance for major projects, those situations should be relatively short-term and well-defined.
 - These situations should be the exception rather than the rule.
 - In fact, this was the original scenario envisioned by OIR through the use of Statements of Work as noted above.
 - As it is now, agencies are securing contractors for long, indefinite periods, as a means to supplement IT staff.
 3. There should be a recognition that it is critical for the state to be able to operate its systems with its own staff.
 - Based on the inefficiencies of using ITPRO contractors and their potential legal liability to the state, serious consideration should be given to reducing the state's information technology dependency on contractors.
 - By hiring state employees when possible, rather than relying on contractors, agencies can enhance morale of employees and promote a more vested buy-in (interest) by employees in the work performed.

III. ACTIONS THAT NEED TO BE TAKEN

A. With regard to the overbillings noted in the Department of Labor and Workforce Development:

The Department of Labor and Workforce Development and OIR need to take actions to improve their oversight of billings by ITPRO contractors. OIR already receives the

information necessary to monitor hours charged to contract, but it does not monitor the hours.

Although initial review of the other ITPRO contractor hours did not reveal additional obvious abuses of time (exceeding 100 overtime hours per month), OIR and the departments utilizing ITPRO contracts should carefully review the hours submitted by the contractors to determine if the hours per project are reasonable, considering the nature of the work. In this review, state officials should be cautious about having the attitude that the contractors are just being paid to fix problems or to get particular results, without regard to the amount of hours they are billing. In fact, they are not being paid on that principle, but rather are being paid on an hourly basis. Under such circumstances, there is no incentive on the part of the vendors and contractors to hold down their costs. Rather, if presented with a scenario in which their billings are going to be paid no matter what the amount, they can control the process by stating they have to work the hours to get the job done without any effective oversight. The state is putting itself into a situation which invites abuses of varying degrees. Basically vendors and contractors are given control over the process.

The departments should also realize that just because they have budgeted the amounts for the contracts, this does not mean they must spend down all the money set aside for the contract. Taking such an approach removes the essence of budgetary controls over contracts and minimizes efforts to review individual billings to make sure they are reasonable.

The departments should also realize when they authorize weekend work in advance, particularly by providing contractors with laptop computers to do work at home, they are relinquishing control over the hours the contractors bill. The less control the department exercises over the location and time of the work of the contractors, the more the departments should take firm steps to assure themselves that the volume and quality of the work provided are commensurate with the hours billed.

B. With regard to the issues relating to the use of ITPRO contractors:

Serious attempts should be made to eliminate present barriers to hiring qualified IT personnel.

OIR management should take a leadership role and immediately review the current use of ITPRO contracts to ensure that all departments using ITPRO contracts, including OIR, provide a reasonable basis for using the contractors—the use will be project specific, for situations truly short-term and for purposes which will not subject the state to possible liabilities to the contractors as state employees in fact. If OIR determines that any departments are not using the contracts appropriately, it should require the departments to promptly refile appropriate SOWs or discontinue the use of the contracts.

OIR should effectively monitor the use of the contractors, to ensure the departments' actual use of the contractors is consistent with the SOWs they have filed.

In the future, OIR should require departments wishing to use ITPRO contracts to submit Statements of Work (SOWs) as provided by the policies governing such contracts and should monitor their use of the contractors to ensure the departments are acting consistently with the SOW.

Each agency should conduct assessments to determine which, if any, contractor positions are deemed critical to meeting the agency's IT needs and initiate steps to convert these to full-time state positions.

Both the agencies and OIR should work with the Department of Personnel to make necessary changes to the employee register system to obtain full-time state employees with the necessary skill and experience levels.

Senior management of the Department of Personnel should take actions to revamp the inflexibility of the register system to assist other state officials in their efforts to recruit and employ needed staff in today's marketplace.

With the overall unemployment situation today, state officials should have to clearly demonstrate they have made a good-faith effort to hire individuals before resorting to contracting for such services, and those efforts should include a continuing process for exploring the market for employees rather than for contractors.

State agencies considering converting contractor positions to state employee positions should be provided with the salaries that the contractors are actually being paid by the vendors. In negotiating state salaries for these positions, state agencies should keep in mind the potential cost savings to be derived from these conversions, taking into consideration the costs of benefits for the new state positions. In other words, the state agencies should seek to obtain the best agreed-upon salary available, consistent with good-faith negotiations, and not merely ratchet up the salary of the new position to be marginally less than the overall cost they were paying to the vendor before conversion.

In filling the new positions, state agencies should also consider hiring individuals who were not in the contractor position before the conversion, if the salary demands of the former contractor are unreasonable. Although cost should not necessarily be the overriding factor in making these hiring decisions, it should be a significant factor.

State officials should not permit vendors and other outside parties having vested interests in the continuation of the ITPRO contracts to exert inappropriate influence in their decisions regarding the conversion of the ITPRO contracts. The easy approach is always to continue to do business as usual, and there will always be many justifications to do just that. However, it is incumbent on top officials to emphasize the interests of the public trust in making such decisions.

IV. BROADER ISSUES

These issues should be a concern for all state agencies using contractors, not only ITPRO.

This report focuses on the ITPRO contracts administered through OIR.

However, the state uses many contractors in many different situations.

Many audits of state departments have reported findings of improper employer-employee relationships for years without corrective action being taken by some departments.

The basic issues noted in this report are applicable to all state contracts.

In light of the budget crisis facing the state, all departments need to consider the true costs of their decisions to contract with third parties rather than using state employees.

This is particularly true since the use of many of these contractors may be subjecting the state to possible legal liabilities for these individuals as de facto state employees.

There will be continuing pressures to contract out more services as a simplistic way to reduce state funding of positions. These pressures should not serve to provide an easy way to make decisions which in the long run will cost the taxpayers even more money and prevent the state from assuming more direct control of the programs and processes incumbent on the state to operate.

Top officials should demonstrate a bias toward action in responding to the issues presented in this report. Every day remedial action is delayed, the costs of misusing contractors rise.

There is a tendency for departments to study matters for extended periods of time rather than take action. Although there is clearly a need to be thoughtful in making major decisions, it should be remembered that many actions, involving considerable expenditure of tax resources, are taken without a great deal of deliberation. In other situations, departments sometimes chart a particular course of action based on thoughtful policies but then let the processes slip into a different course over time, without considering the consequences. An example of such a shift is the way the premise of Statements of Work—project-related engagements—has evolved into a system that lets departments hire contractors to supplant state employees in day-to-day operations.